
Regional Outlook

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FDIC CHICAGO REGION



DIVISION OF INSURANCE

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A Message to Our Readers

The FDIC community extends its deepest sympathy to the families, friends, and co-workers of the victims of the attacks on September 11, 2001.

The articles in this edition of the *Regional Outlook* were prepared before the tragic events of September 11. We will assess the implications of these events in future issues of the *Regional Outlook*. The public can rest assured that deposit insurance is in full force—money is safe in an FDIC-insured account.

Regional Perspectives

- ◆ The net effect of crosscurrents in the Region's economy has been noticeably slower growth and uncertainty about the near-term course for its households and major industries.
- ◆ Rapidly declining interest rates and a steepening yield curve highlight the need for active monitoring of interest-rate risk strategies.
- ◆ Banking conditions remain favorable; however, asset quality indicators reflect trends that may further adversely affect the Region's insured institutions if the economic slowdown continues. *See page 3.*

By the Chicago Region Staff

In Focus This Quarter

- ◆ *Slowing Economy Reduces Demand for U.S. Office Space*—A slowing economy has contributed to softening in many U.S. office markets during the first half of 2001. The office vacancy rate has recorded the largest six-month increase in the past 20 years. A combination of trends—a substantial drop in demand for office space and an uptick in construction activity in some markets—has led to this slackening.

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness. It notes the role played by the changing fortunes of high-tech firms in a number of U.S. metro areas and how this situation has contributed to large increases in the volume of space available for sublease. Finally, the article focuses on the local construction and commercial real estate loan exposures of FDIC-insured banks and thrifts that have the task of managing their risks under changing market conditions. *See page 11.*

By Thomas A. Murray

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Regional Perspectives

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- Banking conditions remain favorable; however, asset quality indicators reflect trends that may further adversely affect the Region's insured institutions if the economic slowdown continues.

Region's Economic and Banking Conditions

Slowdown and Crosscurrents Affect the Region's Economy

The economic slowdown that began abruptly around midyear 2000 continued during the first half of 2001, when positive and negative crosscurrents coexisted in the Region. It is unclear whether the adverse effects of employee layoffs and rising unemployment, weak corporate profits, falling occupancy rates for commercial real estate, and other developments will overwhelm the positive effects from such conditions as lower interest rates, relatively healthy housing markets, personal income tax reductions, and modest inflation.

Labor Markets Weaken and Household Sector Faces Pressures

After growing by 1½ to 2 percent for most of the period since 1996, employment growth in the Region started decelerating in mid-2000 and turned modestly negative in second quarter 2001. Increasing layoffs in the manufacturing sector and smaller employment gains in most other sectors explain the weakening in labor market conditions. In the 12 months ending in June, manufacturing employment fell by 149,000 in the Region, accounting for 21 percent of manufacturing jobs lost nationwide.

In addition to laying off workers, manufacturers trimmed the length of the workweek. These reductions often cut into overtime hours that represent premium pay rates. As a result, average weekly earnings of manufacturing workers leveled out in some of the Region's states and fell in others. Earnings were least affected in **Illinois**, where second quarter 2001 weekly payrolls held close to the year-earlier level. Average weekly earnings fell by 1.3 percent in **Ohio** over the past year and by approximately 2¼ percent in **Indiana**

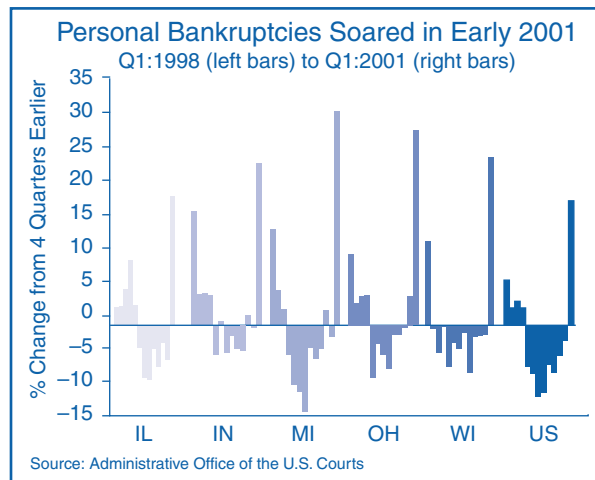
and **Wisconsin**. A 5.0 percent drop in **Michigan** was the sharpest in the Region.

The slowing pace of job growth contributed to a rise in the Region's unemployment rate to 4.5 percent at mid-2001 from a record-low 3.8 to 4.0 percent range from 1998 through 2000. During much of the 1990s, healthy economic conditions in the Region contributed to an unemployment rate about 0.5 percentage points lower than the nation's rate. This gap disappeared in recent quarters, however, as the Region's unemployment rate rose faster than the nation's.

As weakening labor market conditions threatened growth in current and expected incomes, households also faced higher energy prices. Spending for energy rose from a low 4.1 percent of disposable income in 1998 and 1999 to 4.8 percent in early 2001, a share close to the average from 1991 through 1997. This transition, however, squeezed households' discretionary purchasing power, which likely contributed to decreasing levels of consumer confidence. In addition, the average 401(k) account balance in 2000 of continuing participants (those with 401(k) accounts in both 1999 and 2000) showed no gain for the first time in the savings program's 20-year history.

Meanwhile, personal bankruptcies soared in first quarter 2001, driven in part by proposed federal legislation to restrict the terms under which unsecured debts could be erased. The Region's states experienced increases exceeding the 18 percent rise nationwide (see Chart 1, next page), but it is not clear whether this development reflects a relative worsening of the Midwest economy or different attitudes and incentives for filing. In either case, the jump in bankruptcy filings raises the possibility that credit card loan charge-offs could rise later

CHART 1



this year. Should this occur, the impact may not be widespread, as only a few of the Region's insured institutions report significant credit card exposure.

Crosscurrents Found in Real Estate Sectors

Residential resales and permit issuance for new home construction remain high in the Region. This sector's resilience may indicate that the positive effects of declining mortgage rates and relatively high affordability levels for home purchases are mitigating the adverse effects on households' finances of a weaker job market, lower market valuations of equity holdings, and higher energy prices.

In contrast, conditions in nonresidential real estate markets in many of the Region's major metropolitan statistical areas (MSAs) changed fairly abruptly in the past

year. As growth in demand for office and industrial space slackened, the amount of unoccupied space rose in some cities, not only because of new construction but also because previously leased space was returned to the market. (Nationally, the return of leased space to the market soared in the first quarter.) In the Region's largest MSAs, a softening of conditions was widespread in suburban office space over the past year (see Table 1). Meanwhile, a jump in vacancy rates for downtown office space in **Indianapolis** and **Columbus** propelled their rates to among the highest in the nation, although still below levels experienced during the 1980s. To the extent that insured financial institutions headquartered in these MSAs are active lenders in local commercial real estate markets, rising vacancy rates and potential pressure on properties' cash flows could affect the quality of some nonresidential loans.

Farm Sector Challenges Continue

The commercial real estate sector is not alone in facing ample supply relative to demand. Markets for many agricultural commodities face similar conditions, with the result that output prices are relatively low. In addition, farmers are facing challenges from higher energy costs and perhaps fewer opportunities for earning off-farm income. Off-farm income accounts for about 82 percent of small farms' net income nationwide, which suggests that shorter workweeks and layoffs in manufacturing and other nonfarm sectors may adversely affect the financial health of some farm households. Scheduled reductions in farm payments under the Federal Agriculture Improvement and Reform Act of 1996 and the potential for lower levels of emergency aid generate additional pressures on farmers' incomes and debt

TABLE 1

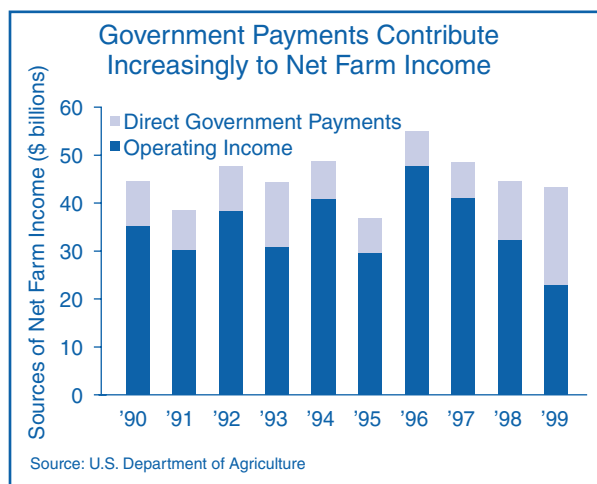
COMMERCIAL VACANCY RATES JUMP IN SOME MARKETS						
METROPOLITAN STATISTICAL AREA	SUBURBAN OFFICE SPACE		DOWNTOWN OFFICE SPACE		INDUSTRIAL SPACE	
	VACANCY RATE (%) Q1:2001	CHANGE FROM Q1:2000	VACANCY RATE (%) Q1:2001	CHANGE FROM Q1:2000	VACANCY RATE (%) Q1:2001	CHANGE FROM Q1:2000
CHICAGO	10.5	0.0	7.9	-0.4	9.3	2.0
CINCINNATI	13.3	2.3	8.8	-0.3	6.5	0.6
CLEVELAND	14.1	3.4	10.3	0.9	7.2	1.4
COLUMBUS	14.4	3.3	17.4	5.7	10.1	0.3
DETROIT	8.7	2.3	17.8	-1.5	8.2	-0.5
INDIANAPOLIS	13.4	6.1	20.8	7.1	6.4	-0.1

NOTE: CHANGE IS MEASURED IN PERCENTAGE POINTS. BOLDFACE INDICATES INCREASE OF 2 OR MORE PERCENTAGE POINTS.
SOURCE: CB RICHARD ELLIS VIA HAVER ANALYTICS, INC.

repayment prospects. These developments are noteworthy because off-farm income and federal government payments represent important components of income for many farmers, as illustrated in Chart 2.

Despite these developments, reported performance of the Chicago Region's 282 farm banks remained relatively stable through first quarter 2001. However, the extent to which "moderate to significant" increases in carryover debt observed by FDIC examiners in the past two years contribute to the steadiness in reported asset quality is unclear. Overall, agricultural banks appear vulnerable in the current environment not only because of the challenges facing farmers but also because these insured institutions tend to be less diversified than other small banks in their lending portfolios and sources of income.¹

CHART 2

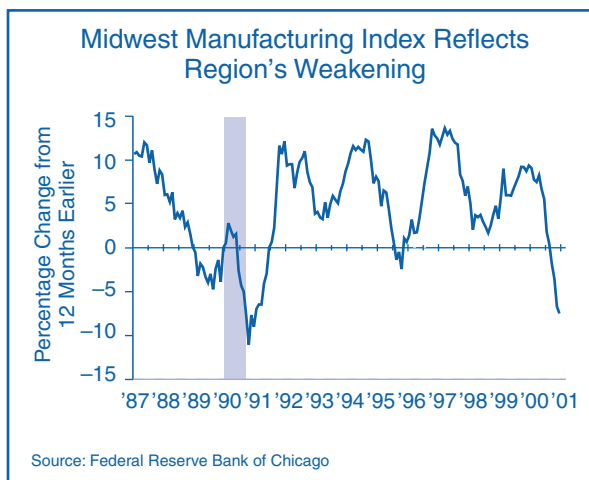


Manufacturing Sector's Inventory Correction Is a Key to Region's Near-Term Health

The manufacturing sector accounts for about 23 percent of the Region's economy, in contrast to 16 percent nationwide. In many industries, high inventory stocks relative to sales are resulting in production and employment cutbacks. The extent of the Region's slowdown since mid-2000 is illustrated by the Midwest Manufacturing Index (see Chart 3), which reflects the composite behavior of 16 industries important to the Chicago Region. Negative effects from the sector's current weakness and employee layoffs could spread to other sectors important to the area's overall economic health.

¹ For an in-depth analysis of agricultural conditions and the effect on farm banks, see Kansas City Regional Perspectives in *Regional Outlook*, second quarter 2001.

CHART 3

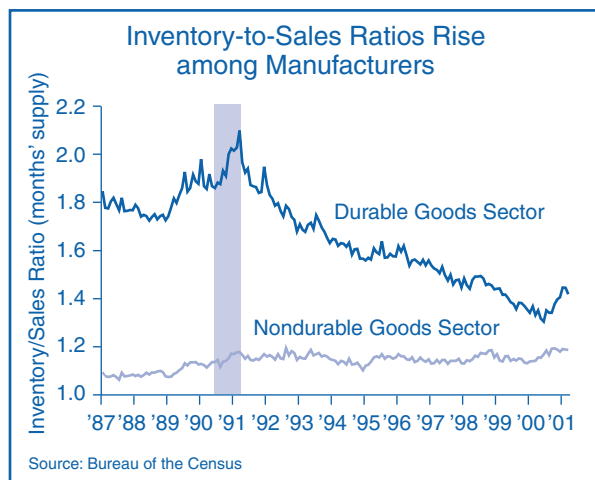


An unplanned rise in inventories relative to sales has been most pronounced in the durable goods sector (see Chart 4, next page). Because this sector has a relatively large presence in the Region, a rebound in the area's economic vitality is unlikely until excess inventories are reduced. Indicators of when this is likely to occur are mixed.

However, the process seems well under way in the automobile and light truck sectors. There, generous incentives offered by producers and lower interest rates sustained a high level of vehicle sales through midyear, while production was trimmed by 16 percent between second quarter 2000 and first quarter 2001. Consequently, the inventory-sales ratio for domestic automobiles at midyear 2001 was considerably lower than at year-end 2000, and production of motor vehicles and parts increased in the second quarter.

In contrast, the inventory-sales ratio for the primary metals (mainly steel) industry in early 2001 matched the 1998 high (when a decline in foreign demand and intense international competition dampened sales), despite a 12 percent reduction in U.S. production during the past year. Stocks of fabricated metal products relative to sales also rose noticeably, reaching a nine-year high even though production was trimmed by 6 percent in the past four quarters. Sharp increases in inventories relative to sales also took place in late 2000 and early 2001 among producers of wood products and nonmetallic mineral products (e.g., stone, clay, and glass). Less severe imbalances developed in other industries important to the Region's manufacturing sector.

CHART 4



How Crosscurrents Will Play Out Is Unclear

Falling interest rates during the first half of 2001 contributed to lower debt-servicing burdens for businesses and households and enhanced the ability of creditworthy borrowers to obtain funds. Lower rates also may help bolster flagging consumer confidence in the face of a weakening economy. To the extent that lower interest rates spur businesses and households to purchase manufactured goods, the potential for near-term correction of inventory-to-sales imbalances is enhanced.

In addition, federal tax rebates and reduced withholding rates under the Tax Relief Act of 2001 may help stimulate the economy during the second half of 2001. To provide some context for the magnitudes involved, the aggregate increase in household energy bills nationwide over the past year approximates the \$45 to \$55 billion of tax relief expected in the second half of 2001. However, it is not clear whether the households struggling with energy bills are the ones benefiting from tax rebates and lower withholding rates.

When and how vigorously the Region's current economic sluggishness ends will depend on how the current crosscurrents net out against one another in coming quarters. Positive developments in the first half of 2001 include the significant lowering of interest rates, continuing strength in the residential housing sector, and significant correction of the inventory-to-sales imbalance in the motor vehicle sector. The manufacturing sector and commercial real estate activity are likely to remain sluggish, however, until current imbalances are resolved.

Rapidly Changing Interest Rates Highlight Need for Active Interest Rate Risk Monitoring

Sharp reductions in short-term interest rates since the start of the year have implications not only for the economy but also for interest rate risk management at insured institutions. A falling interest rate environment is generally a favorable development for most insured financial institutions. Lower short-term rates may help liability-sensitive institutions² boost net interest margins and may improve the repayment prospects of some borrowers. However, the significant balance sheet restructurings that often occur during a period of rapidly changing interest rates can strain interest rate risk management.

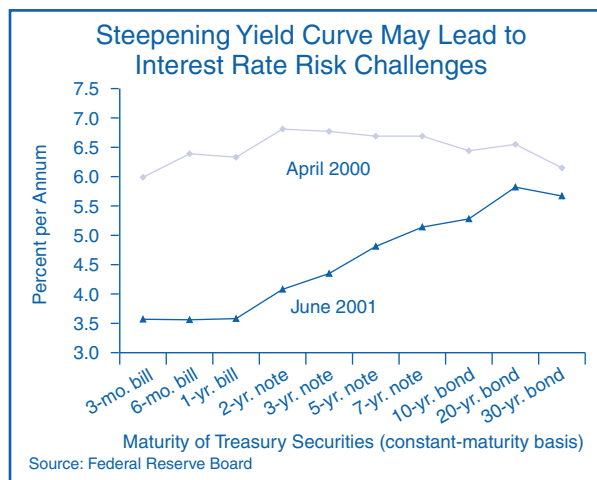
Periods of rapidly falling interest rates often lead to the realization of option risk in banks' balance sheets. For instance, borrowers often have the option to prepay high coupon loans, and depositors may choose to withdraw funds in search of more attractive yields. During the early part of 2001, refinancing activity accelerated sharply, with many borrowers opting to lock in longer-term fixed-rate mortgages.³ Such a high level of refinancing activity may have led to shifts in asset maturity distributions at some banks and unwanted prepayment of higher yielding assets at others. Some newer institutions may be the most challenged by rapidly changing interest rates, as interest rate risk monitoring practices typically take some time to refine, particularly if the emphasis is on the generation of loan and deposit relationships.

The relatively steep yield curve at midyear 2001 (see Chart 5) may provide an incentive for banks and thrifts to seek longer-term assets and shorter-term funding sources in response to net interest margin compression seen at community institutions. While this could prove beneficial in the short run, prudent interest rate risk management requires a relatively balanced interest rate risk position that can withstand sharp interest rate fluctuations in either direction.

² Liability-sensitive institutions generally have liability structures with expected maturity or repricing of shorter duration than their earning assets. If these positions are not hedged, such institutions' net interest margins typically decline in a rising interest rate environment and improve in a falling interest rate environment.

³ According to the Mortgage Bankers Association, 11 percent of mortgages closed in the first half of 2001 were adjustable rate, compared with 31 percent a year earlier.

CHART 5



Asset Quality Pressured by the Slowing Economy

Asset quality trends among the Region's insured institutions reflect some deterioration, but overall reported asset quality levels appear favorable. Although aggregate capital levels are high, increased loan-to-asset levels and growth in traditionally higher-risk commercial and industrial (C&I) loans and commercial real estate (CRE) loans occurred during the 1990s. Recently, loan demand has moderated, with loan growth peaking in the second quarter of 2000. In addition, less frequent occurrences of the most risky general underwriting practices were noted in the FDIC's most recent underwriting survey.⁴ Current prudent underwriting bodes well for asset quality as newly originated or renewed credits season. However, should asset quality concerns arise as a result of a slowing economy, they may be associated with credits that are just now becoming seasoned.

Asset Quality Weakens at Large Institutions⁵

Larger insured institutions in the Chicago Region have experienced some adverse asset quality trends, much like large institutions throughout the nation. As of March 31, 2001, large institutions' past-due and nonaccrual (PDNA) to total loans ratio stood at 2.42 percent, the highest level in 12 quarters and 53 basis points higher than a year earlier.⁶ This trend has been fairly widespread among this group of institutions.

⁴ FDIC Report on Underwriting Practices, October 2000 through March 2001.

⁵ Large institutions are defined as those with more than \$1 billion in assets, excluding credit card and other specialty institutions.

⁶ The past-due and nonaccrual (PDNA) ratio for large institutions as of March 31, 2001, was the highest first quarter reading since March 31, 1993, but still well below first quarter levels seen in 1991 and 1992, which were above 4 percent.

Reserve coverage of nonperforming loans has been declining since year-end 1999. Although large institutions have been making provisions in excess of net charge-offs in recent quarters, which has led to a higher reserve to total loan ratio, this has not completely offset the growth in nonperforming loans that has occurred, primarily in C&I loan portfolios. The growth in nonperforming loans is particularly noteworthy given the recent increase in charge-off rates. A sharp increase in net charge-off rates occurred in fourth quarter 2000, and in the case of the Region's largest institutions, rates climbed further in first quarter 2001.⁷

The interagency **Shared National Credit Review** program, which is conducted annually and covers any syndicated loan of more than \$25 million, also provides insight into large institution asset quality trends. As of 2000, the review program reported two consecutive years of significant increases in adversely classified and criticized credit volumes, albeit from a very low base. Indications from the 2001 review are that this trend will continue.

Community Institutions Also Are Experiencing Some Weakening in Asset Quality

The Chicago Region's community institutions⁸ also have experienced some adverse asset quality trends (discussed below), which could intensify if economic conditions fail to improve. In addition, community banks in the Region increased loan-to-asset levels during the 1990s, as well as exposure to historically riskier asset classes, such as CRE and C&I lending (see Table 2, next page). The combination of increasing volumes of commercial lending and higher loan-to-asset levels places community institutions' profitability more at risk to slower economic growth.

Loan Delinquencies Have Risen. Although delinquencies in major loan categories remain well below levels seen in the early 1990s, they have increased during the past year (see Chart 6, next page). Recent years' delinquency ratios may have been understated because of fairly rapid loan growth. As loan growth has subsided and the economy has slowed, delinquency ratios may continue to trend upward as these newly issued credits season.

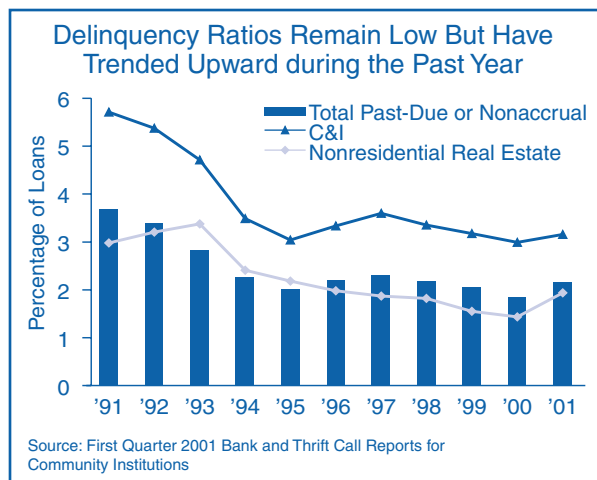
⁷ Annualized net charge-offs for the Region's largest institutions (more than \$10 billion in assets) reached 0.71 percent of average loans for the first quarter of 2001, versus 0.56 and 0.44 percent in the fourth and third quarters of 2000, respectively.

⁸ Community institutions are those with less than \$1 billion in assets, excluding de novos (institutions established within the past three years) and specialty institutions.

Future trends in community banks' nonresidential real estate portfolios may prove to be the most important, as the percentage of institutions with significant CRE concentrations has increased considerably during the 1990s. Nonresidential real estate has been the primary driver of rising CRE portfolios; as a result, rising vacancy rates may further pressure delinquency ratios.

During the past ten years, the percentage of institutions with PDNA ratios in excess of 5 percent held fairly steady, but the percentage has risen markedly during the past year. As of March 31, 2000, 8 percent of community institutions met this threshold, compared with 11 percent as of March 31, 2001. Institutions with a focus on CRE, C&I, or agricultural lending comprise a significant percentage of institutions with high PDNA ratios.

CHART 6



Charge-Offs Remain Low. Weaker economic conditions also could adversely affect collateral valuations and repayment prospects. Recent annual charge-off data for community banks appear low by historical standards. For the year 2000, aggregate net charge-offs were 0.17 percent of total loans; they have been in a fairly narrow range between 0.19 percent and 0.15 percent since 1994. During the past decade, net charge-offs peaked for community institutions in 1991 at 0.45 percent of loans. The aggregate allowance for loan and lease losses (ALLL) ratio reported for first quarter 2001 was 1.09 percent, the lowest first quarter ratio in the past decade. Therefore, any rise in net charge-offs could affect profitability more significantly than in recent years.

Asset Quality Ratings. Asset quality ratings for the Region's community institutions generally look favorable on a historical basis, but the percentage of community institutions with asset quality ratings of 3, 4, or 5 has risen during the past several years. As of March 31, 1997, 64 institutions, or 3.2 percent, had weak asset quality ratings. This number had risen to 124 institutions, or 7.5 percent, as of March 31, 2001.

In addition to rising levels of credit exposure during the past decade, insured institutions generally faced an increasingly competitive environment, particularly for traditional funding sources. This competition, on both sides of the balance sheet, has left community banks with significantly lower net interest margins in spite of increased credit exposure. Although aggregate profitability has held up well, this has largely been attributable to a low level of problem loans and corresponding loan loss provision expenses, as well as successful efforts to cultivate noninterest income sources during a

TABLE 2

REGION'S COMMUNITY INSTITUTIONS HAVE INCREASED CREDIT EXPOSURE DURING THE PAST DECADE			
SELECTED INDICATORS (%)	MAR '90	MAR '96	MAR '01
LOANS-TO-ASSETS	63	64	69
CRE LOANS TO TOTAL LOANS	17	14	14
C&I LOANS TO TOTAL LOANS	18	21	26
INSTITUTIONS WITH CRE > 200% OF TIER 1 CAPITAL	19	20	32
EQUITY CAPITAL	7.41	9.42	9.62
ALLL / GROSS LOANS	1.04	1.20	1.09
C&I = COMMERCIAL AND INDUSTRIAL; CRE = COMMERCIAL REAL ESTATE; ALLL = ALLOWANCE FOR LOAN AND LEASE LOSSES SOURCE: BANK AND THRIFT CALL REPORTS			

rapidly expanding economy. The recent economic slowdown places these positive trends somewhat at risk. In fact, noninterest income levels pulled back slightly in 2000, possibly an indication that growth in this category was already moderating. Many fee-generating sources of income, such as trust activities and nondeposit investment sales, are particularly sensitive to market declines and could stagnate pending improvement in equity markets.

What Lies Ahead?

Although the FDIC's most recent underwriting survey notes that institutions are not generally engaged in risky underwriting practices, recent economic softness may affect asset quality, as loans originated several

years ago may be the most likely to present challenges in the near future. The impact will likely be greatest on those institutions that have been the most aggressive in their selection of risks. As risk management strategies are implemented, institutions should consider the potential for less favorable economic conditions and place appropriate emphasis on early identification and supervision of problem credits. Furthermore, slowing economic growth has contributed to sharp reductions in short-term interest rates, which may result in improved profitability for some institutions but may present interest rate risk management challenges for others.

By the Chicago Region Staff

Slowing Economy Reduces Demand for U.S. Office Space

- **Demand for U.S. office space contracted during the first half of this year as the amount of newly vacated space exceeded the amount of newly occupied space for the first time since at least 1981.**
- **The U.S. office vacancy rate jumped 250 basis points in the first half of 2001, from 8.3 percent to 10.8 percent.**
- **With construction levels remaining high and demand still weak, the vacancy rate could rise further by year-end.**

Overview

Commercial real estate (CRE) markets traditionally have been—and remain—highly cyclical. During the 1990s, most U.S. office markets experienced a strong upswing. However, declining office employment growth along with other recent signs point to a possible downturn. As reported by *Torto Wheaton Research* (TWR), the U.S. office vacancy rate, which stood at a 19-year low of 8.3 percent at the end of 2000, jumped in only six months to 10.8 percent, the largest six-month increase in the 20 years TWR has tracked these data. Office vacancy increases range from modest levels in some markets to high levels in markets where supply and demand imbalances are more pronounced.

An uptick in construction activity combined with a substantial drop in demand for office space has led to a slackening of office market conditions. In light of the ongoing uncertainty as to the near-term direction of the U.S. economy, these trends make the current situation difficult for office market participants to read.

This article reviews recent developments in U.S. office markets and describes demand-side and supply-side trends that have contributed to the recent weakness.¹ It notes the role played by the changing fortunes of

high-tech firms in a number of metropolitan areas and how this situation has increased the volume of space available for sublease. Finally, the article focuses on the local construction loan exposures of insured banks and thrifts that have the task of managing their risks under changing market conditions.

Vacancy Rates Have Risen Quickly from Cyclical Lows

At year-end 2000, the U.S. office vacancy rate stood at 8.3 percent—a 19-year low. Many individual metro areas posted even lower vacancy rates. For example, at year-end 2000, vacancies were 4.4 percent of available space in Seattle, 1.3 percent in San Jose, and 3.0 percent in Oakland. Beginning with first quarter 2001, as a result of a slowing economy and the fallout from the so-called “tech-wreck,” the U.S. vacancy rate rose by 120 basis points to 9.5 percent—the highest absolute quarterly increase since these data were first published in 1981. Another record increase of 130 basis points occurred during the second quarter, bringing the vacancy rate to 10.8 percent. To put these increases in perspective, consider that the national office vacancy rate has increased more than 50 basis points in any given quarter only twice.² Nonetheless, the current vacancy rate of 10.8 percent remains low by historical standards, as the average rate for the past 20 years has been 13.9 percent.

Most of the nation’s large metro areas saw increases in office vacancies during the first half of 2001. Forty-eight of the 53 major metropolitan areas tracked by TWR recorded a higher vacancy rate in June 2001 than at year-end 2000. Thirty-eight markets experienced increases of at least 100 basis points, and four markets saw vacancy rates jump by more than 600 basis points. As shown in Table 1 (next page), most of the markets experiencing the largest jump in vacancy rates also are home to concentrations of high-tech employment.³ As

¹ For further discussion of demand and supply trends, see Sally Gordon, “CMBS: Red – Yellow – Green™ Update, Second Quarter 2001 Quarterly Assessment of U.S. Property Markets,” *Moody’s Investors Service*, July 6, 2001.

² TWR notes increases of 60 basis points in the second quarter of 1989 and in the first quarter of 1999.

³ Seven of the ten markets with the highest first-half 2001 vacancy rate increases are also among the top ten cities having the greatest levels of high-tech employment.

TABLE 1

IN MANY MARKETS, OFFICE VACANCY RATES REFLECT CONCENTRATIONS OF HIGH-TECH EMPLOYMENT				
METRO AREA	VACANCY RATE AS OF 6/30/01 (%)	VACANCY RATE AS OF 12/31/00 (%)	INCREASE IN VACANCY RATE (BASIS POINTS)	HIGH-TECH AS % OF TOTAL MARKET EMPLOYMENT
AUSTIN	11.8	5.0	680	10.1
SAN JOSE	8.1	1.3	680	27.4
OAKLAND	9.3	3.0	630	6.5
SAN FRANCISCO	10.3	4.1	620	8.3
SEATTLE	9.4	4.4	500	6.6
KANSAS CITY	15.9	11.0	490	2.7
BOSTON	8.7	3.9	480	8.2
PHOENIX	16.9	12.5	440	4.7
WILMINGTON, DE	10.4	6.2	420	3.8
WASHINGTON, DC	7.8	3.9	390	7.8
NATION	10.8	8.3	250	4.8

SOURCES: TORTO WHEATON RESEARCH, ECONOMY.COM, INC.

high-tech markets spurred higher demand for office space in the recent past, these markets are now giving back greater quantities of previously occupied office space. Table 2 (see page 18) lists office vacancy rates and changes along with lending concentrations, construction activity levels, and high-tech employment percentages for 53 major metropolitan areas and for the nation.

Unlike the last cycle, during which office vacancies shot up primarily in overbuilt downtown areas, recent increases are occurring more sharply in suburban than downtown sections of metropolitan areas. As of June 30, 2001, the average downtown office vacancy rate was 8.5 percent, and the average for suburban markets was 12.1 percent. Increases in office availability are dispersed among Class A office properties as well as Class B/C properties, yet vacancy rates do show disparities across many submarkets. For example, the South of Market area in San Francisco reports significantly higher office vacancy rates than the Financial District.⁴ Similarly, in the Washington, DC, metropolitan area, the technology-intensive northern Virginia office market has experienced higher office vacancy increases than downtown Washington, DC, or suburban Maryland.

⁴ Louis, Arthur M. July 24, 2001. "Empty Offices, Economic Downturn, Overconstruction Leave Commercial Landlords with More Space on their Hands." *San Francisco Chronicle*.

Office Demand Drops

Net absorption, the primary indicator of demand for office space, was negative during first quarter 2001 for the first time since TWR began reporting the series.⁵ (Negative absorption occurs when space returned to the market by existing tenants exceeds the space occupied by new tenants.) This negative performance was repeated in the second quarter. The decline in the volume of competitively leased space totaled 30 million square feet during the first half of 2001. (See Chart 1.)

The bulk of negative absorption in the first half of 2001 is due to the return of office space to the market through subleasing.⁶ TWR reports that there were 43 million square feet of space "give-backs" through subleasing in the first half of 2001, and after offsetting absorption of 13 million square feet, negative absorption was 30 million square feet.

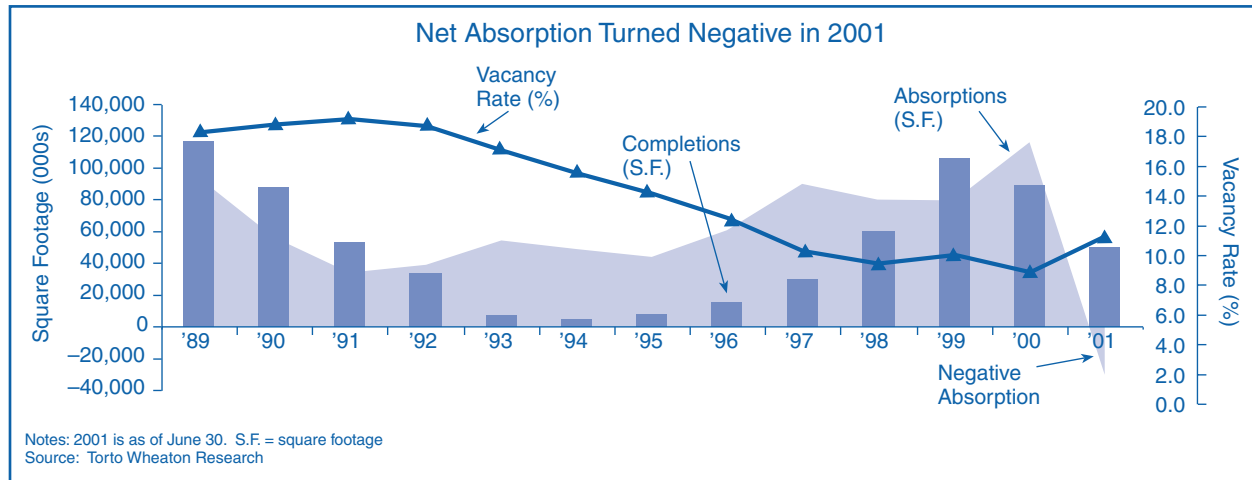
Office employment growth, the source of new office space demand, tends to be driven by the finance and services sectors.⁷ Year-over-year job growth in the finance,

⁵ Net absorption is the net change in total competitively leased space per period, as measured in square feet.

⁶ In some metropolitan areas, over half the total office space available for rent (vacant space) is sublease space.

⁷ TWR constructs its office employment index based on trends in the FIRE sector plus selected categories of the services sector. See *TWR Office Outlook*, Spring 2001, Vol. II, p. A.1.

CHART 1



insurance, and real estate (FIRE) and services sectors combined was more than 3 percent in every month from January 1993 through June 2000. Since the middle of 2000, job growth in these sectors has fallen steadily to a year-over-year rate of less than 1.5 percent in June 2001. A spring 2001 survey conducted by **Salomon Smith Barney** indicated that tenants estimated their growth in office space demand to be only 0.6 percent over the following 12-month period.⁸ Also contributing to reductions in demand are increases in worker layoffs. Announced layoffs during the first seven months of 2001 totaled over 983,000 individuals, more than triple the number of announced layoffs during the same period last year.⁹

The slowdown in the demand for office space contrasts sharply with the situation last year, when absorption rates and office employment growth were robust in most markets, and leases were executed quickly for newly constructed properties. As shown in Chart 2, absorption of office space in 2000 actually outstripped the trend in office employment by a considerable margin. Why? With relatively easy access to initial public offering and venture capital funding, many startup firms anticipated rapid growth and leased office properties accordingly. In fact, venture capital funding facilitated historically higher rates of office space absorption by high-tech and other startups. In active bidding wars, new high-tech firms increased their office space holdings. A phenomenon of *space hoarding* developed in which some high-tech companies leased large quantities of office space in anticipation of future expansion.

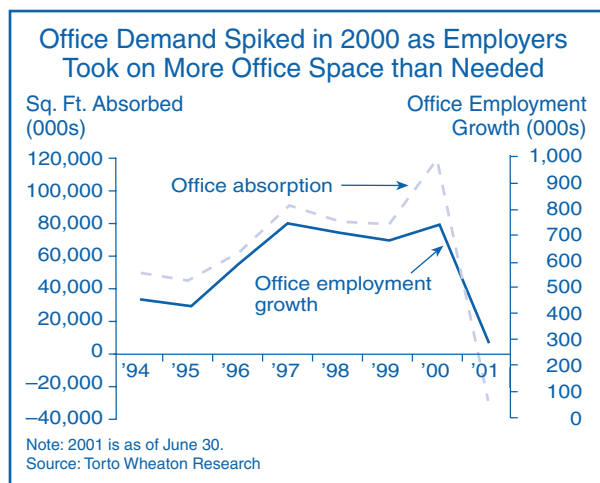
⁸ Boston, Gary, Ross Nussbaum, and Jonathan Litt. May 16, 2001. "Real Estate Demand Survey." *Equity Research: United States, Real Estate Investment Trusts*, Salomon Smith Barney.

⁹ Data provided to Haver Analytics by Challenger, Gray & Christmas.

More recently, because of a slowing economy, curtailed funding, and failures to achieve sales expectations, many high-tech and dot-com firms have closed or scaled back operations significantly. At the same time, traditional firms have reconsidered plans to expand, adopting a "wait and see" attitude. Consequently, as demand for space declines, large blocks of office space are returning to markets for sublease.

Space available for sublease is similar to landlord-offered space available for rent—space under both categories should count toward a market's available rental space. However, in the case of subleasing, tenants, rather than landlords, offer properties for rent. Tenants may attempt to sublease the property themselves or use a broker; however, in general, only space handled by a broker is included in the tally of a market's available rental space. Consequently, current office vacancy increases could be higher than reported.

CHART 2



Meanwhile, Construction Continues

An uptick in office construction activity that began in many metro areas during the late 1990s has been a key element contributing to recent increases in office vacancies. According to the *Bureau of the Census*, U.S. expenditures on office construction totaled \$47.5 billion in 2000, continuing a seven-year cycle of expansion. Adjusted for inflation, this amount represents about 78 percent of the peak level of office construction expenditures that occurred in 1985. Recently, the pace of construction has slowed slightly, falling to an annualized rate of \$44.3 billion in May 2001.

Reflecting these large dollar outlays on office construction, TWR projected in December 2000 that 111.3 million square feet of new office space (or 3.6 percent of existing stock) would be completed during 2001. This newly completed space will come on the market following a period of rising construction activity from 1998 through 2000, during which the volume of completed office space averaged 84.9 million square feet per year. As shown in Chart 3, however, current office construction activity as a percentage of existing stock falls well below that of the 1980s.

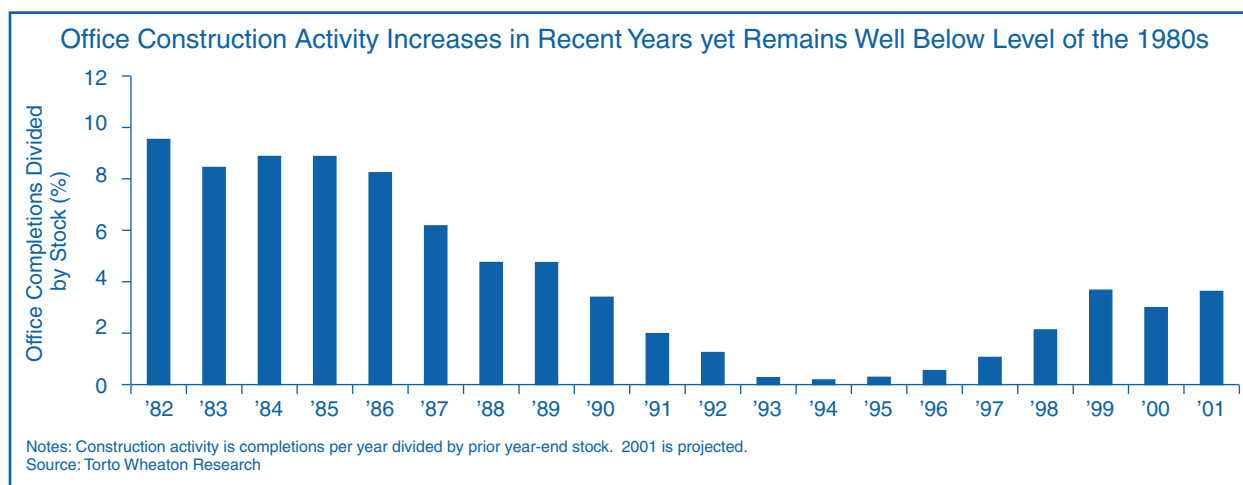
Many metropolitan areas currently experiencing high levels of construction activity also are seeing the largest increases in office vacancies. For example, cities that are positioned toward the upper right quadrant of Chart 4 are characterized by higher vacancy rate increases and more new office space construction. The ten cities with the highest first-half 2001 vacancy rate increases had total square footage of under-construction office space at 6.5 percent of existing stock as of year-end 2000.¹⁰ By comparison, total office space under construction nationally was 4.5 percent of existing stock.¹¹

Even as most projects move toward completion, some developers are reconsidering office construction plans. Builders have stopped construction of significant projects midstream in the Austin, Dallas, Seattle, and northern Virginia markets in response to retrenchment by major tenants and competition from subleased space.

Softening Extends to Other Commercial Real Estate

Other major commercial real estate markets are also feeling the effects of a slowing economy and, with the exception of the retail sector, are experiencing increasing vacancy rates.

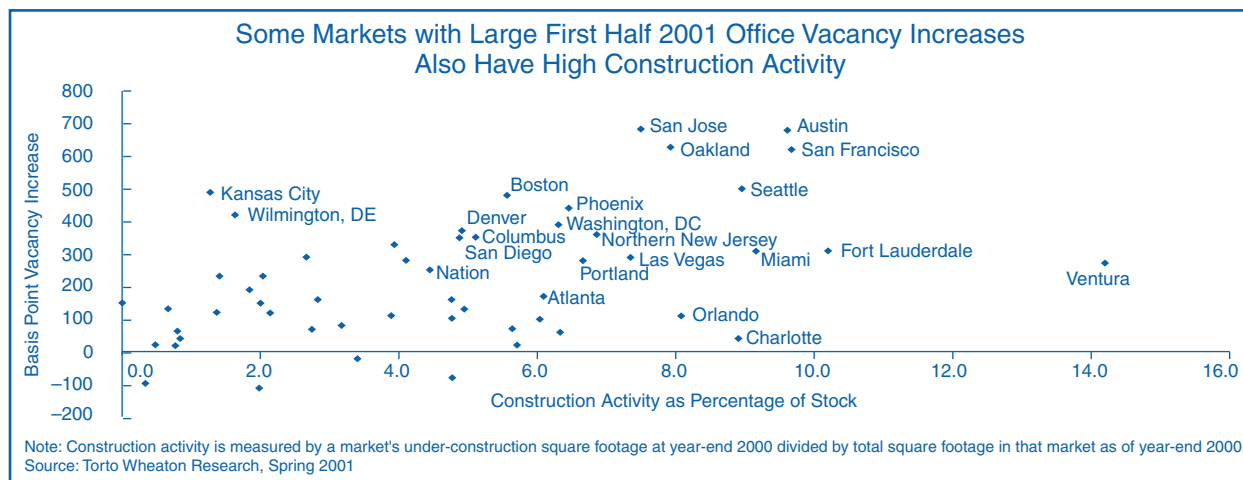
CHART 3



¹⁰ One measure of a metropolitan area's exposure to overbuilding and rising vacancy rates is the degree of construction activity. This measure is found by dividing a metropolitan area's completions square footage or the under-construction square footage by the total stock of office property.

¹¹ The national 4.5 percent level for office properties *under construction* at December 2000 is higher than the 3.6 percent level for projected *completions* in 2001 because not all properties being built in 2001 will be completed during the year.

CHART 4



Industrial vacancy rates had fared well in recent years. As of year-end 2000, the national vacancy rate of 6.7 percent was the lowest since 1984. Now, however, a 150-basis-point increase has occurred, with industrial vacancies increasing to 8.2 percent in the first half of 2001.¹²

As the economy and the nation's high-tech and manufacturing sectors continue to slow, demand for industrial space for research and development and storage and distribution is declining. Industrial property subleasing is on the rise, and negative absorption occurred in the first half of 2001. At the same time, completions of industrial space during 2001 are estimated to exceed 220 million square feet, the highest level since 1988. Landlords are offering concessions, such as lease terms of one year compared with five to ten years, in an attempt to attract new tenants.

Industrial properties are somewhat less exposed to risks from overbuilding than office properties because of shorter construction periods and the ability to respond quickly to any change in demand. An exception is the *telecommunication hotel*,¹³ a new entry into this market. This property type is characterized by a longer construction cycle and the fact that it typically has a "single use" design. In recent months, construction of these structures began in many high-tech markets to provide enhanced levels of data service. With declining demand, some telecom hotels stand vacant.

¹² Torto Wheaton Research.

¹³ Telecom hotels are large, high-energy-consuming warehouses that house machinery, servers, routers, and switches that are the physical underpinning of the electronic commerce conducted on the Internet. They are hotels in the sense that they house equipment belonging to many different telecommunication companies. John Holusha, "Home for Machinery of the Internet," *The New York Times*, August 16, 2000.

The demand for **hotel** rooms is adversely affected by a slowing economy. Businesses have cut travel budgets and consumers have scaled back leisure plans, contributing to a decline in occupancy levels and revenue per available hotel room in most markets throughout 2001. Currently, upscale and luxury hotels are suffering more than limited service hotels. According to *Smith Travel Research*, limited service hotels, particularly budget hotels, represent the only lodging sector with higher occupancy levels through the first four months of 2001 when compared to the same four month period in 2000.

The supply of new hotel properties is lower than in the past, as financing for new hotel construction for the most part has been curtailed in recent years. However, limited service hotels are reported to be overbuilt in a number of markets in the Southeast and Southwest.¹⁴ Annualized expenditures for new construction of all hotel types were \$12.1 billion as of May 2001, falling to the lowest level since 1996.¹⁵

The **multifamily** sector has experienced robust construction and equally strong absorption in recent years as new household formation, the driver for apartment demand, continues to increase. Annualized construction expenditures of \$25.5 billion as of May 2001 were at the highest level since 1989.¹⁶ Despite the relative equilibrium between supply and demand for apartments in most markets, vacancy increases and rent declines are occurring in some locations. This decline has been most acute

¹⁴ Kozel, Peter P. June 18, 2001. "U.S. Commercial Property Markets in a Slowing Economy: Implications for CMBS Credit Performance." *Standard and Poor's Structured Finance*.

¹⁵ Data provided to Haver Analytics by U.S. Bureau of the Census.

¹⁶ Ibid.

in the more concentrated high-tech markets, such as San Francisco, where reported average rental rates dropped 8.1 percent between the end of March and the end of May 2001.¹⁷

Despite a slowing economy, the **retail** sector has performed reasonably well, as consumers maintain relatively high spending levels. Many of the store closings in 2000 and 2001 have been absorbed by new tenants as landlords have acted quickly to avoid letting vacant space linger. Meanwhile, robust construction has continued, with total expenditures in 2000 of \$52.6 billion and an annualized level of \$52.2 billion as of May 2001. Each of these two years' expenditure levels exceeds all previous years' retail construction amounts since data were first gathered in 1964.¹⁸

Taking note of the robust level of retail construction activity, a recent **Moody's** article finds that the nation's mall retail and "power center"¹⁹ space grew by 3.3 percent in 2000, while population growth expanded by only 1.2 percent. The article raises concerns for potential excess supply of retail space resulting from a construction rate that is almost triple the population growth rate.²⁰ A negative consequence of the high rate of retail construction is found in a recent **Standard and Poor's** study. This article points out that most of the retail mortgages (held in commercial mortgage-backed pools of assets) that defaulted during 2000 did so because of competition from new retail establishments.²¹

Implications for Insured Institutions

Office vacancy rates during the first half of 2001 increased at an unprecedented rate. What does this mean for insured institutions? On the one hand, at mid-2001 vacancy rates remained below their 20-year average. Yet the speed of the increase and the number of

metropolitan areas that have experienced softening make this a trend that deserves the close attention of insured institutions, especially those with significant concentrations in commercial real estate and construction lending.

Financial indicators of real estate credit quality in banking remain favorable, with losses and delinquencies trending up modestly from minimal levels. Noncurrent construction and development (C&D) loans as of March 31, 2001, remain at a relatively low .92 percent of all outstanding C&D loans. (Noncurrent C&D loans as a percentage of all C&D loans averaged .93 percent for the past five year-ends.) Similarly, noncurrent CRE loans²² as of March 31, 2001, were .82 percent of all CRE loans, a level consistent with the average for this ratio of 1.08 percent for the past five year-ends. Charge-off ratios at March 31, 2001, for both C&D and CRE loans were each at .02 percent and remain below the averages of .05 percent for each for the past five year-ends. These favorable numbers are the legacy of a strong economic expansion, whereas current economic events suggest the potential for future deterioration in credit quality.

The outlook for commercial real estate credit quality depends on the depth and duration of the current economic slowdown and on the risk management practices of each institution. In this regard, as signs of increasing risk materialize in conjunction with a declining economy, lenders appear to be managing risks prudently and avoiding speculative lending.²³ Anecdotal information suggests that borrowers are pressed to obtain higher prelease commitment levels in order to gain loan approvals. In addition, lenders are requiring more up-front equity.^{24,25}

The importance of risk management practices is magnified by the heightened lending concentrations currently prevailing at some banks. Institutions with elevated concentrations in CRE and C&D lending have been more likely to experience significant problems during times of economic stress (for further details,

¹⁷ Associated Press, News in Brief from the San Francisco Bay Area, June 13, 2001.

¹⁸ Data provided to Haver Analytics by U.S. Bureau of the Census.

¹⁹ According to the Urban Land Institute, a power center is a community shopping center in which at least 75 to 90 percent of the selling space is devoted to multiple off-price anchors and a discount department store or warehouse club. It is the "power" of its anchors that gives the center its name.

²⁰ Sally Gordon, op. cit.

²¹ Kozel, Peter P. April 20, 2001. "Outlook for Property Markets in a Slower-Growing Economy and the Implications for CMBS Credit Performance." *Standard & Poor's Structured Finance*.

²² CRE loans are nonfarm, nonresidential loans secured by real estate.

²³ Speculative construction lending is defined as a loan not accompanied by a meaningful presale, prelease, or take-out commitment.

²⁴ "Capital Is Still Plentiful for Right Projects." *Midwest Real Estate News*. July 2001. Vol. 17, No. 7.

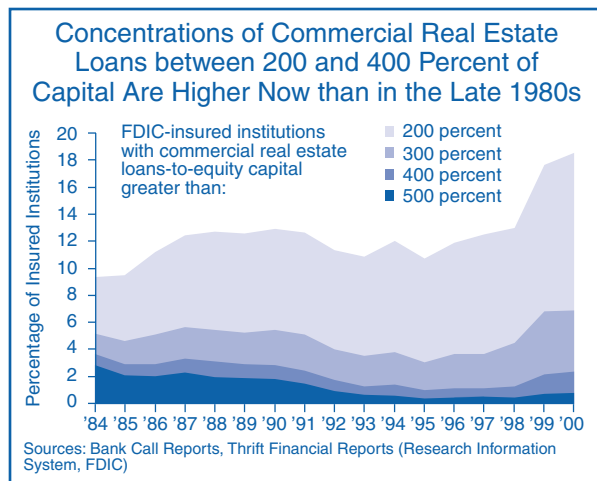
²⁵ Further information on bank underwriting practices can be found in Federal Deposit Insurance Corporation, Division of Research and Statistics, *Report on Underwriting Practices*, <http://www.fdic.gov/bank/analytical/report/index.html>.

see *History of the Eighties*²⁶). As shown in Chart 5, the percentage of insured institutions with commercial real estate loan concentrations between 200 and 400 percent of capital is higher now than it was in the late 1980s. However, there are relatively fewer institutions at the highest concentration level, in excess of 500 percent of capital. In fact, fewer than 1 percent of insured institutions are at this level. A similar story holds true for construction loans, as the increasing concentrations are in the range of 100 to 300 percent of capital (see Chart 6).

There are a number of issues for construction lenders and commercial real estate lenders to consider going forward. Because uncovered loans (C&D loans made without assurances of a firm take-out commitment) tend to be higher-risk, an important part of managing the risk in construction lending has traditionally been the lender's ability to obtain a take-out commitment.

Sources of take-outs for C&D loans include other insured institutions, pension funds, foreign investors, and life insurance companies, along with public-market real estate investment trusts (REITs) and conventional mortgage-backed securities (CMBs). Anecdotal reports indicate that shifts in market sentiment in recent months have resulted in lowered investments in REITs and consequently less available capital for REITs to purchase real estate.²⁷ Insured institutions

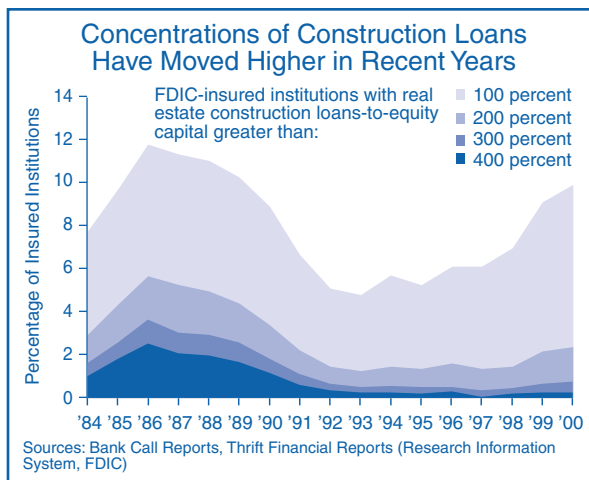
CHART 5



²⁶ Federal Deposit Insurance Corporation. *History of the Eighties—Lessons for the Future, Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s*, Chapters 9 and 10. 1997. Washington, DC: FDIC. <http://www.fdic.gov/bank/historical/history/index.html>.

²⁷ Smith, Ray A. August 1, 2001. "Property Held by Public Firms Drops." *The Wall Street Journal*.

CHART 6



may face increased challenges to convert construction and development loans into permanent loans should the reported REIT situation become a trend and other sources of permanent capital become less available to purchase C&D loans.

Monitoring economic trends in general, and local real estate trends in particular, becomes even more important during a time of rapid change in market conditions. For example, reliance on appraisals based on outdated or top-of-market assumptions can result in a divergence between expected and realized collateral values or cash flows. Similarly, while preleasing commitments offer significant risk-reduction benefits to lenders, during a time of weakening economic conditions there is at least the possibility that a prospective tenant will be unable to honor a lease obligation, as has been the case with some firms in the high-tech sector in recent months.

Conclusion

Office market trends cannot, of course, be considered in isolation. The recent softening in office markets is a symptom of a slowing economy coupled with a rapid decline in the fortunes of some high-tech firms. Considered in this broader context, the challenge for insured institutions is simply to ensure that risk-management strategies are in place that will succeed under a more challenging economic environment.

Thomas A. Murray
Senior Financial Analyst

TABLE 2

OFFICE MARKET AND BANKING DATA ON 53 METROPOLITAN AREAS						
METROPOLITAN STATISTICAL AREA	2ND QUARTER 2001 OFFICE VACANCY	BASIS POINT INCREASE FROM YEAR END 2000	COUNT OF COMMUNITY BANKS WITH C&D LOANS	MEDIAN C&D AS PERCENTAGE OF TIER 1 CAPITAL AT 3/31/2001 (%)	HIGH-TECH AS PERCENTAGE OF TOTAL MARKET EMPLOYMENT (%)	OFFICE SPACE UNDER CONST/ STOCK AT 12/31/2000 (%)
ALBUQUERQUE	11.6	-110	9	61.0	6.8	2.0
ATLANTA	9.8	170	76	172.2	3.8	6.1
AUSTIN	11.8	680	20	53.4	10.1	9.6
BALTIMORE	8.9	60	60	22.8	3.6	6.3
BOSTON	8.7	480	100	24.1	8.2	5.6
CHARLOTTE	9.0	40	20	48.5	1.7	8.9
CHICAGO	8.9	130	225	33.5	4.5	4.9
CINCINNATI	10.1	100	58	32.6	3.1	6.0
CLEVELAND	13.6	40	16	34.8	3.0	0.8
COLUMBUS, OH	16.9	350	20	22.4	3.1	5.1
DALLAS	16.4	110	75	84.5	6.5	3.9
DENVER	12.7	370	45	70.4	5.2	4.9
DETROIT	12.0	160	28	35.2	3.1	2.8
FT. LAUDERDALE	12.8	310	13	19.1	2.7	10.2
FT. WORTH	16.4	130	36	71.8	3.4	0.7
FRESNO	14.4	20	5	196.0	0.9	0.8
HARTFORD	14.0	150	11	25.2	3.5	0.0
HONOLULU	12.6	-190	3	11.4	0.9	0.0
HOUSTON	13.6	60	48	65.8	3.1	0.8
INDIANAPOLIS	15.8	120	21	29.6	3.3	1.4
JACKSONVILLE	11.7	-20	11	65.2	1.8	3.4
KANSAS CITY	15.9	490	86	70.8	2.7	1.3
LAS VEGAS	14.5	290	19	117.7	1.5	7.3
LONG ISLAND	10.9	190	6	19.1	5.3	1.8
LOS ANGELES	14.1	150	62	35.4	3.7	2.0
MIAMI	10.5	310	26	28.1	1.8	9.2
MINNEAPOLIS	10.8	20	119	44.0	6.0	5.7
NASHVILLE	12.8	230	20	78.4	1.2	2.0
NEW YORK	5.1	230	34	10.5	2.4	1.4
NORTHERN NEW JERSEY	10.9	360	66	15.0	5.6	6.9
OAKLAND	9.3	630	12	120.0	6.5	7.9
OKLAHOMA CITY	20.3	20	44	57.8	2.6	0.5
ORANGE COUNTY	14.7	330	14	34.5	6.4	3.9
ORLANDO	13.1	110	23	72.1	2.3	8.1
PHILADELPHIA	10.7	80	68	22.1	4.5	3.2
PHOENIX	16.9	440	27	114.2	4.7	6.5
PORTLAND, OR	9.9	280	14	118.8	6.6	6.7
RIVERSIDE	14.4	-100	18	143.5	1.6	0.3
SACRAMENTO	6.6	70	11	106.9	3.9	5.6
SALT LAKE CITY	15.3	280	14	111.7	4.5	4.1

TABLE 2 (CONTINUED)

OFFICE MARKET AND BANKING DATA ON 53 METROPOLITAN AREAS						
METROPOLITAN STATISTICAL AREA	2ND QUARTER 2001 OFFICE VACANCY	BASIS POINT INCREASE FROM YEAR- END 2000	COUNT OF COMMUNITY BANKS WITH C&D LOANS	MEDIAN C&D AS PERCENTAGE OF TIER 1 CAPITAL AT 3/31/2001 (%)	HIGH-TECH AS PERCENTAGE OF TOTAL MARKET EMPLOYMENT (%)	OFFICE SPACE UNDER CONST/ STOCK AT 12/31/2000 (%)
SAN DIEGO	9.7	350	21	57.5	6.6	4.9
SAN FRANCISCO	10.3	620	21	69.0	8.3	9.7
SAN JOSE	8.1	680	5	174.5	27.4	7.5
SEATTLE	9.4	500	30	77.1	6.6	9.0
ST. LOUIS	10.1	-80	80	40.4	2.6	4.8
STAMFORD	11.2	290	10	43.5	5.6	2.6
TAMPA	14.8	70	33	40.0	4.2	2.7
TUCSON	8.8	100	3	178.4	4.4	4.8
VENTURA	14.2	270	8	49.7	5.4	14.2
WASHINGTON, DC	7.8	390	61	51.1	7.8	6.3
WILMINGTON, DE	10.4	420	12	28.4	3.8	1.6
W. PALM BEACH	12.2	160	18	37.2	2.3	4.8
WESTCHESTER	12.5	120	4	19.5	12.3	2.1
NATION	10.8	250	(1) 3,801	(1) 40.1	(2) 4.8	(2) 4.5
NOTES: ONLY COMMUNITY BANKS WITH CONSTRUCTION LOANS ARE INCLUDED IN THIS TABLE. COMMUNITY BANKS ARE INSTITUTIONS WITH ASSETS LESS THAN \$1 BILLION. NONCOMMUNITY BANKS ARE EXCLUDED BECAUSE THEIR LENDING ACTIVITIES ARE LIKELY TO SPAN A LARGER AREA THAN THE MSA IN WHICH THEY ARE HEADQUARTERED. SOURCES: TORTO WHEATON RESEARCH; BANK AND THRIFT CALL REPORTS, FDIC RESEARCH INFORMATION SYSTEM DATA; ECONOMY.COM, INC. 1. ONLY COMMUNITY BANKS WITH CONSTRUCTION LOANS AND LOCATED WITHIN A MSA ARE INCLUDED IN THESE FIGURES. 2. PERCENTAGES SHOWN ARE THE AVERAGES FOR THE 53 METROPOLITAN AREAS.						

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